THE MISSOURI BUDGET

FY 2004 BUDGET SUMMARY

STATES FIGHTING FOR THEIR FINANCIAL LIVES

For the past two years state governments across the country have been fighting for their financial lives. After collectively fighting off budget deficits of over $50 billion when enacting their Fiscal Year 2003 budgets, the slumping economy and fast growing health care expenditures have created more than $50 billion in additional deficits in the current year. In addition, states face new deficits estimated at between $60 and $85 billion for Fiscal Year 2004.

The fiscal crisis facing Missouri is similar to that facing the other states.

- In Fiscal Year 2002, Missouri experienced the first decline in net general revenue collections since 1955, ending with 3.5 percent less in net general revenue collections than the year before.
- The revised revenue estimate for Fiscal Year 2003 projects that the state will collect $195.8 million less net general revenue than in Fiscal Year 2002 – the second year in a row of declining collections.
- Well-intentioned federal tax cuts enacted in 2001 and 2002 designed to stimulate the economy will reduce state revenues by an estimated $146.6 million in Fiscal Year 2004 and by almost $300 million when the tax cuts are fully implemented. In addition, the President and the U.S. Congress may speed up the effect of the previously approved federal tax cuts that will further reduce Missouri revenues.
- The economy officially went into recession in March 2001 and this recession has yet to be declared over. In addition, even when the recession ends the economy is expected to grow slowly in the next year, particularly with the threat of war and higher oil prices.
- Individual income tax withholding has been weakening as unemployment increases and as workers work hours are reduced.
- Corporate income and corporate franchise taxes combined will decline again in Fiscal Year 2003.
- The stock market's performance during calendar year 2002 will likely result in a substantial additional decrease in taxes on capital gains on state tax returns filed in April 2003 even when compared to the dramatic decrease seen in April 2002.
- Given the current economic outlook, the revenue estimate for Fiscal Year 2004 projects less net general revenue than collected in Fiscal Year 2002.
- General revenue has essentially been stagnant since Fiscal Year 1999 – a five-year period during which costs of health care and corrections increased significantly.

The slumping economy, federal tax cuts that sap state revenue, and rapidly increasing health care costs have required decisive action each year to balance the budget. While the federal government is allowed to run a deficit, Missouri state government must balance its budget each year. Like Missouri families, our state government must live within its means.

Governor Holden has implemented $893 million in mid-year budget cuts over three fiscal years:

- Withheld $76 million in Fiscal Year 2001.
- Withheld $749.5 million in Fiscal Year 2002.
- Withheld $67.1 million so far in Fiscal Year 2003. As a result of the withholdings a total of 870 jobs will be eliminated for the remainder of the year, including 96 layoffs and 774 positions that will remain unfilled.

Under Governor Holden, the state has implemented the largest permanent budget cuts and most extensive redirection of spending priorities to ever take place:

- $895 million in general revenue core budget cuts in Fiscal Year 2002 and Fiscal Year 2003.
- Over 1,000 jobs had been eliminated prior to those withheld in January 2003.

Missouri's actions and the Governor's values can be put into perspective by seeing how other states are responding to severe economic times. First, in Fiscal Year 2003 when 17 other states cut funding for local schools the Governor fought hard to obtain a $134.9 million increase for the Foundation Formula. So far, both our local schools and colleges and universities have been spared withholdings in Fiscal Year 2003. Second, Missouri's most vulnerable citizens – children and the elderly – have been protected to the greatest extent possible. Third, public safety and corrections, which are essential to protecting our citizens from crime, have been preserved. Missourians can see the effect of the Governor's priorities in the services they receive. Administrative cuts have been deep. K-12 education has been protected.

The Fiscal Year 2004 budget presents the most difficult challenge to face a Governor and the General Assembly since the Depression. The chart below reveals the depth of the state's current financial difficulties:

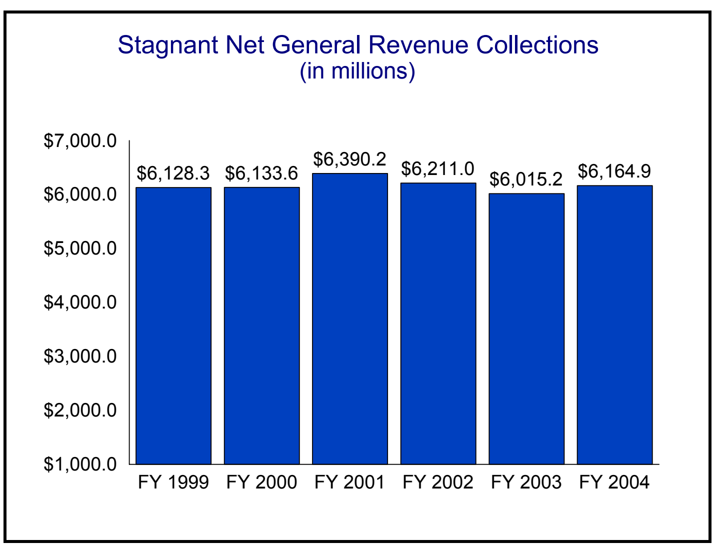
- Fiscal Year 2003 net general revenue collections are now estimated to be $6,015.2 million, a total of $290.5 million below the $6,305.7 million on which the budget is based.

- Fiscal Year 2003 net general revenue collections are now estimated to be $195.8 million below those actually received in Fiscal Year 2002, a 3.2 percent decline – the second year of declining revenues.

- Fiscal Year 2003 revenue includes $436 million in non-recurring revenue that will be unavailable in Fiscal Year 2004.

- Fiscal Year 2004 net general revenue collections will increase by $149.7 million over the projected final Fiscal Year 2003 estimate, an anemic 2.5 percent growth and much less than needed to replace the non-recurring revenue.

- Fiscal Year 2004 net general revenue collections will be $140.8 million <u>below</u> the amount needed to support the budget approved for Fiscal Year 2003.



PROTECTING OURSELVES FROM FEDERAL FINANCIAL ACTIONS

The national financial policies already implemented and currently proposed are counterproductive.

- Well-intentioned federal tax cuts enacted in 2001 and 2002 designed to stimulate the economy will substantially reduce Missouri revenues during Fiscal Year 2003 and future years.

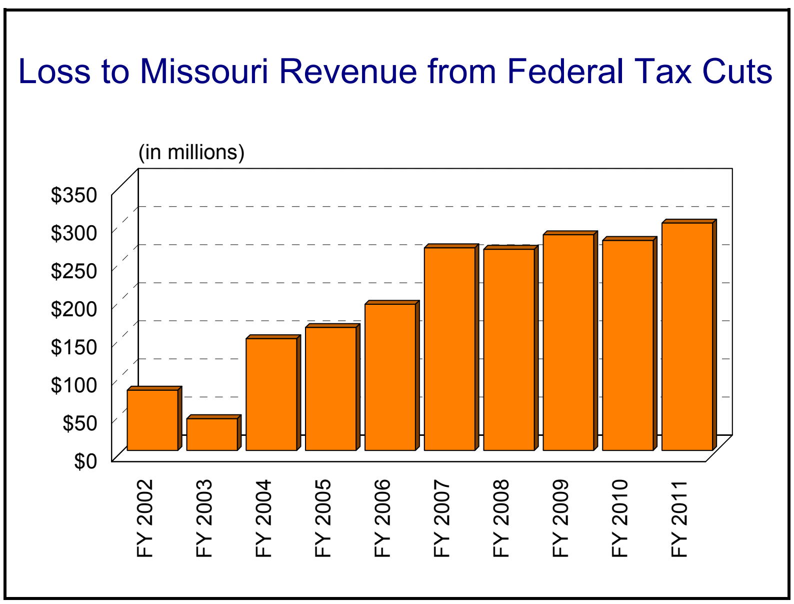
- It is impossible for the states to grow themselves out of their fiscal crises if the federal government continues to give away the state revenue base. Indeed, the current proposals being discussed to move up the effective dates of the previous federal tax cuts will further reduce Missouri's revenues.

- Forcing Missouri and the other states to continue to enact dramatic cuts in services or raise taxes dissipates, if not completely eliminates, any stimulative effect of the federal tax cuts.

- The National Governor's Association has proposed a $12 billion initiative to provide assistance to the states to help them deal with the dramatic cost increases in the Medicaid program. States have already been forced to implement tough cost-containment measures to slow the growth in their Medicaid expenditures including cutting people from eligibility, eliminating optional programs, and reducing payments to hospitals, doctors, and other providers.

- Instead of shared sacrifice to prepare for and win the war on terrorism and the possible war with Iraq, we are told that we can increase spending and have tax cuts, thereby dramatically increasing the federal deficit. Those policies have never worked in our nation's history and are unlikely to work now.

The Governor recommends legislation that will require the General Assembly to approve any changes in the federal tax statutes before they can affect Missouri tax revenues. The Governor's recommendation applies to all changes including both increases and decreases. Currently, the Missouri tax code is tied tightly to the federal tax code. Thus, the President and U.S. Congress can change Missouri state tax policy without fear that they will be held accountable for the damage that those changes inflict. The Missouri General Assembly should be given the opportunity to weigh every federal change to ensure that Missouri's 197 elected representatives determine that the changes are in the best interests of the state and its citizens.



CORE BUDGET REVIEW

The Governor has been discussing the expected budget shortfalls for several months. He convened a Budget Summit with the members of the General Assembly back in September 2002. Since then, he has traveled throughout the state to Fair Share Budget hearings to make sure Missourians know tough actions are being taken and what is at stake for them for the future. The Governor believes:

- Taxpayers must be assured the budget is managed in a fiscally responsible way and administrative costs are minimized so important services can be funded. We have already cut almost $900 million general revenue in the Governor's first two budgets and eliminated about 1,000 positions. This allowed the budget to be balanced and made available money to fund high priorities, such as: the school foundation formula; health care coverage for low-income children, the elderly and the disabled; and prescription drug coverage for low-income seniors.

- Missourians must be assured that every penny of tax they pay is spent efficiently, effectively, and is focused on achieving the highest priority results.

- Citizens must be assured that all taxpayers are paying their fair share to support vital state sources; examining tax loopholes is the first step.

Missouri has been doing performance-based budgeting since the 1970s. Indeed, Missouri has been nationally recognized for both its efforts in performance measurement and in strategic planning. Missouri has used performance information to help the state cut millions of dollars from the budget. Performance budgeting is infused in the entire budget process used by the Governor and the General Assembly. Performance information is available on every budget decision item narrative in every department budget. Performance information is also readily available through the internet at the website for the Managing for Results Initiative (www.mri. state.mo.us). Governor Holden's Managing for Results Initiative (MRI) is a long-term commitment to doing business more efficiently and effectively by focusing on customer satisfaction, process improvement, and problem solving.

The state does not need increased statutory strings requiring a mind-numbing review of the effectiveness of every purchase of paper clips. The supposed justification for these approaches is the belief that the "core" budgets are never reviewed. Nothing could be further from the truth. Governor Holden has proven, with almost $900 million in core cuts already, that aggressive, targeted, and thoughtful core cuts can be implemented to dramatically improve administrative efficiency while at the same time protecting local schools and the state's most vulnerable citizens. The Governor has done all of this while still maintaining the state's AAA bond rating which recognizes Missouri as one of the best-managed states in the nation. The Governor does not need new authority to review the core budget or to improve administrative efficiency. He and his administration think about it and do it every day, every month, and every fiscal year with substantial recommendations to change the way state government operates.

For Fiscal Year 2004 the Governor demanded that agencies submit spending plans with zero growth. A thorough three-month performance-based review of existing programs was completed. Agencies were then asked to submit any new items for funding that they believed were mandatory increases for the Fiscal Year 2004 budget. These requests were thoroughly evaluated and agencies were ordered to withdraw non-mandatory items. This process was more rigorous than the Georgia model for budgeting that is often mentioned as the answer to Missouri's budget woes. And it was accomplished within the current statutory framework.

This intensive review of existing programs will result in reform of government operations while maintaining required services as described below.

- <u>Core cuts and cost containment - $256.7 million</u> – This includes $159.2 million in core budget cuts, bringing the Governor's three year core cut total to $1.054 billion. Governor Holden demands that state departments continue to provide quality service by working smarter and more efficiently. Aggressive cost containment initiatives in the Medicaid program are recommended resulting in $88 million in slower growth in addition to $51 million in Medicaid core cuts included above. These initiatives include expanding pharmacy controls, requiring copays on many services and prescriptions, implementing a more efficient non-emergency transportation system, prior authorizing optional services, and reducing pharmacy reimbursement to a level more consistent with private health care systems. The Department of Corrections cut its budget request from $70.3 million to $60.6 million through cost containment efforts and increased flexibility in how a portion of the department's funds may be spent. By allowing flexibility, the department can operate more efficiently, saving taxpayer dollars.

- Early retirement – State government needs to get smaller. Providing an early retirement incentive during a "window" period is a time honored and effective practice of corporations seeking to reduce their workforce and the associated salary and benefit costs. The goals of an early retirement incentive are to decrease the number of state employees, reduce the personnel costs of the state, and reorganize the state workforce. A number of states adopted early retirement incentives last year as a means of dealing with their fiscal problems and more will likely follow this year. Within Missouri, the Department of Conservation and the University of Missouri have implemented successful early retirement incentives twice during recent years.
  - ⇒ Current pension benefits are not sufficient to entice very many state workers to retire when they are first eligible - only about 25 percent of eligible state employees take advantage of the state's "80 and out" retirement provision. The major reason that so few state workers retire at the earliest opportunity is the dramatic increase in health care costs that they must pay when they become retirees. State government salaries are substantially lower than private sector salaries so most workers cannot afford the dramatic increase in health care premiums.
  - ⇒ The Governor's proposed plan would provide four years of additional service as an incentive to retire. However, the plan recognizes that simply offering to add years of service credit is unlikely to sufficiently entice state workers to retire and save the state money. Accordingly, the plan also recommends that the state treat the retirees who take this option like active employees for health care premium purposes. From the time they retire until they are eligible for Medicare those that retire under the Governor's plan will pay the same amount of health care coverage as active state employees. This should be a powerful incentive. Employees will be given a 90-day window to decide whether they will retire under this temporary provision.
  - ⇒ The early retirement incentive is anticipated to save the state $24 million. These savings are achievable only because the state is expected to refill no more than 25 percent of the positions of those who leave and the average salaries for those who do fill these positions should be lower than the salaries of those who retired. The Office of Administration will be given the responsibility to work with the agencies and decide which positions will be refilled. The savings from the plan will be core cut from each agency in the Fiscal Year 2005 budget to ensure that the state gets permanent savings from the plan.

- Reorganizations – It has been almost 30 years since the last comprehensive reorganization of state government. Since that time numerous programs and entities have been added to state government, resulting in duplication and overlap of many state services. In addition to core reductions we must make our government the most streamlined and efficient as possible, by organizing around agencies' primary missions. Restructuring key services will improve the way we deliver services to the taxpayers of Missouri. Governor Holden's proposal to restructure state government will achieve $4.9 million in savings in Fiscal Year 2004 and eliminate 169 state staff. To improve departmental operations in the interest of economy, efficiency, and better service Governor Holden will file reorganization plans with the General Assembly to improve the operation of the state's executive branch by:

⇒ Creating a Children's Division to focus on children in state custody and those at risk of abuse or neglect.
⇒ Consolidating Workforce Development functions into the Department of Economic Development.
⇒ Eliminating the Division of Highway Safety and transferring its functions to the Department of Transportation.
⇒ Eliminating the Division of Child Support Enforcement and transferring its receipt and payment processing functions to the Department of Revenue and the support order establishment function to the Family Support Division.

- Statewide administrative actions to reduce spending – The Governor is implementing the following actions:
  ⇒ Sell three state aircraft – The state will sell three state aircraft including the jet and purchase a single turboprop airplane to cut excess capacity. The sale will generate about $1 million in revenue for the state.
  ⇒ Reduce state owned vehicles – The Governor has mandated at least a ten percent reduction in the state vehicle fleet. The state will prohibit the use of state vehicles for any employee's commute to and from work. The state will eliminate vehicles assigned to individual state employees and place a moratorium on the purchase of new vehicles except on critical replacements. Vehicles used to ensure the safety of Missouri citizens, such as the Highway Patrol, will be excluded from these reductions.
  ⇒ Reduce printing and mailing costs – By law, state agencies are required to produce hundreds of reports and publications. The state will make more of these publications available over the Internet, thus saving on paper, printing, and storage costs. The state will also work to dramatically expand the use of e-mail to reduce mailing costs.
  ⇒ Consolidate office space – The state is redoubling its efforts to eliminate leased offices or consolidate small offices into larger leased facilities throughout the state.
  ⇒ Eliminate warehouse space – The Office of Administration has been ordered to eliminate excess warehouse space throughout state government and coordinate the sharing of space to improve efficiency and save money.

- Commission on Efficiency and Fiscal Management - Even though the Governor has spent the past two years improving efficiency and reducing spending throughout state government, he has welcomed additional ideas and recommendations from the private sector. To gather additional ideas, the Governor will create the Missouri Commission on Efficiency and Fiscal Management by an executive order. The Commission will immediately undertake a complete, comprehensive, and thorough examination of all aspects of the State's cash management practices, debt management practices, budgetary process, personnel practices, and other areas relevant to sound business and financial practices. The Commission will provide recommendations to the Governor, General Assembly, and the citizens of Missouri on any additional ways to make the government of Missouri more efficient, effective, fiscally sound, and productive in cash and fiscal management and business and finance in general.

- Automatic Sunset Date for New Programs – The Governor recommends that every new program enacted in state statute include an automatic date that it will end, or "sunset", if not renewed by the General Assembly. This process has already been used for some selected state programs in the past ten years. However, the Governor's proposal would:
  ⇒ Require a review of every new program that will result in a recommendation to reauthorize, modify, or eliminate the program based on its performance.
  ⇒ Establish program reviews by the staff of the Joint Committee on Legislative Research – a process that is already available.
  ⇒ Eliminate or modify programs that are not successful.
  ⇒ Trigger reauthorization legislation on programs that are found to be

meeting performance results and providing benefits that outweigh the costs of the program.

- Managing for Results Initiative – Governor Holden's Managing for Results Initiative (MRI) is a long-term commitment to doing business more efficiently and effectively by focusing on customer satisfaction, process improvement, and problem solving. Agency projects have saved millions of dollars and countless hours for Missouri citizens and state employees. Descriptions of these projects can be found at the MRI website (www.mri.state.mo.us). Some select MRI projects that have already made significant progress include:

  ⇒ Workers' Compensation Team – Changes are being implemented to get injured workers back to productive work more quickly. It is anticipated that these changes will result in a $1.5 million reduction in workers' compensation costs to the state and an additional 40,000 days of productivity from employees being back at work.

  ⇒ Child Support Enforcement Team – Changes are being implemented that will increase the amount of money paid to custodial parents to help support their children. So far, undistributed collections have been reduced by 50 percent.

  ⇒ Department of Transportation Team – Recommendations are being put in place to reduce the number of projects where actual costs exceed the original projection. These changes should reduce these cost overruns from the current 72 percent of projects down to 15 percent, saving millions of state highway dollars.

  ⇒ Water Quality Permits Team – Improvements are being implemented to reduce the time it takes to issue water quality permits by the Department of Natural Resources. These changes will reduce the time it takes to receive state permits by two months, freeing staff to spend more time inspecting sites to ensure the quality of Missouri's water meets state and federal standards.

MORE EFFICIENT COLLECTIONS AND TAX EXPENDITURES

Increase collections already owed

The first way to assure Missourians that they are paying their fair share in taxes is to show them that the state is working hard to collect taxes that are already owed. The Governor's plan includes:

- Aggressive administrative efforts by the Department of Revenue - $18.9 million – Missourians were given an opportunity to come into compliance with the state's tax code in the just completed and successful tax amnesty. However, now that amnesty is completed the state will hire additional specially trained auditors, criminal investigators, and other staff to ensure that all Missourians pay their fair share of taxes. In addition, the state will enter into a contingency fee contract to upgrade the department's collection system using a benefit-based agreement. The vendor will only be paid provided the system enhancements generate new revenue in excess of an agreed upon baseline.

- Require electronic filing of some taxes - $2.2 million – The proposal would allow the director of revenue to require electronic filing of monthly and quarter-monthly withholding returns, corporate estimated tax payments, and quarter-monthly sales tax payments. This will ensure quicker deposit of funds into the state treasury.

Reduce Spending on Tax Loopholes

The Governor has been saying for months that Missourians want and demand a Fair Share Budget. We must stop giving away money through special tax loopholes that benefit few corporations and place a significant percentage of Missouri businesses at an economic disadvantage. We must also eliminate tax loopholes that do not expand the economy. The loopholes that should be closed will save $185.6 million and include:

- Geoffrey loophole - $15 million – National franchises set up dummy corporations in other states to avoid a large portion of Missouri taxes. Illinois and 25 other states have provisions to close this loophole. Missouri must pass such a provision as well.

- Refunds to purchasers - $10 million - Currently, a business that applies for and receives a sales tax refund for taxes they have inappropriately collected from customers is not required to even attempt to find and return the overpayment to the purchaser. A cottage industry of consultants has developed to mine businesses for such sales tax refunds. As a result, sales tax refunds have increased from $15.4 million in Fiscal Year 1996 to $65.0 million projected in Fiscal Year 2004. State Auditor Claire McCaskill has identified this abuse as a loophole in our current sales tax law.

- Yacht loophole - $4.2 million – Buyers of boats over five tons are allowed to pay a watercraft tax instead of Missouri sales tax. This limits the maximum amount of the tax on a $300,000 boat to about one percent of the cost of the boat compared to the six percent sales tax that a purchaser of a smaller boat must pay.

- Disallow non-Missouri source income - $31 million – Missouri may be the only state that allows corporations to avoid paying state taxes on income from out-of-state investments such as bank deposits, stocks, and some loans. This loophole encourages out-of-state investments and applies only to corporations and not individual taxpayers.

- Disallow single factor - $77.2 million – Most corporations earn their income through business activities in a number of different states. However, Missouri's tax code gives corporations an enormous advantage not given by other states by giving them the opportunity to choose the method of determining what portion of the corporation's income is taxed by Missouri. Single factor apportionment is extremely generous to taxpayers who make most of their sales to out-of-state customers but rely heavily on Missouri infrastructure because they have facilities and employees here. Giving money away through this loophole only benefits about four percent of corporations that file income taxes in Missouri.

- Common carriers - $9.8 million – Years ago the legislature enacted sales tax exemptions for purchase of trucks, parts, and repairs for "common carriers." When these exemptions were passed, every common carrier was required to register with the federal Interstate Commerce Commission allowing only true common carriers, i.e., trucking companies for hire by the general public, to qualify. Today, anyone can register as a common carrier by paying a relatively modest fee and such registration is no longer required in most cases. As a result, we have seen a substantial number of companies form trucking subsidiaries that carry essentially only the goods of the parent, but call the subsidiary a common carrier in order to claim these exemptions.

- Franchise tax dissolution - $1.0 million – Allows the Secretary of State to dissolve a corporation for not filing a franchise tax return.

- Professional licensing - $10 million – This proposal requires individuals to receive a tax clearance to ensure that state owed taxes are paid before an individual can obtain or renew a professional license, local business permit, or license, or be considered an eligible vendor to contract with the state.

- Gambling winnings - $7 million - Currently, there is no Missouri law explicitly requiring a nonresident individual to be taxed on winnings from a multi-jurisdiction lottery (including power ball), lotto, riverboat gaming. Residents must pay taxes on their winnings. However, nonresidents can engage in multi-jurisdiction lottery, lotto, and riverboat gaming and collect their winnings without a legal obligation to file a Missouri individual income tax return and pay Missouri income tax on all their winnings.

- Railroad retirement double deduction - $2 million - Currently, a taxpayer receiving railroad retirement benefits is not taxed on those benefits at the state level and also may deduct up to $6,000 from their Missouri taxable income. In effect, this proposal would eliminate the double dipping.

- Eliminate timely filing discount for withholding tax - $18.4 million - Missouri businesses receive a discount for sending the income withholding taxes they collect from employees to the state. In other words, businesses keep a substantial amount of these taxes that employees believe they are paying to government for the services they receive. The state of Missouri is the only state that provides this discount, which has been in effect since 1973 and was originally justified on the basis that businesses needed lots of clerks pushing paper to figure out how much withholding should be remitted to the state. However, in the Internet age, computers calculate the amounts and the money can be transmitted to the state in seconds. The discount no longer recognizes the cost of this task and should be eliminated.

MORE REVENUE NEEDED

Only when Missourians are assured that we have cut spending, are vigorously working to collect all that the state is owed, and reduced spending on loopholes can we ask for a revenue increase. The point has been reached that without a significant infusion of new revenue the state will fail in its basic obligations to our citizens. We will be unable to protect, or may be forced to reduce, the Foundation Formula payments to local schools. Major budget cuts would be required in higher education, thus substantially increasing tuition for students and their families. Thousands of the elderly, the poor, and the disabled would have their medical and mental health services eliminated. The revenue package proposed by the Governor does not include a general tax increase on Missourians. The Governor's plan taxes voluntary behavior such as gambling and cigarette usage, places a surcharge on wealthy Missourians, and reduces federal control of our budget. At the same time, the Governor also recommends decreasing taxes to spur economic activity in the state. The Governor's plan includes:

- Gaming - $193 million – The Governor's plan to ensure that the Foundation Formula is protected from crippling budget cuts includes new revenue initiatives from riverboat gaming. These initiatives include:
  - ⇒ 2% increase in tax on riverboat gaming receipts – $30 million. The current adjusted gross receipts tax is 20 percent which is shared by the state (18 percent) and the local governments where the riverboats are docked (2 percent). The Governor's proposal raises the state share to 20 percent and leaves the local share at 2 percent.
  - ⇒ $2 increase in riverboat gaming admission fee - $106.3 million. The current $2 admission fee will be increased by $2 under the Governor's proposal.
  - ⇒ Eliminate loss limits on riverboat gaming - $56.7 million. Missouri is the only state in the nation with a loss limit on riverboat gaming. The limit prevents Missourians and visitors from participating in gaming to the fullest extent and puts the state's casinos at a competitive disadvantage while not providing an effective deterrent for problem gamblers.

- Cigarette tax - $278.5 million – Tobacco use in Missouri is one of the highest in the nation; 27 percent of adults smoke. Even more alarming are recent studies that indicate one-third of Missouri teenagers are smoking. As a result, Missouri ranks well above average in smoking-related diseases such as heart disease, cancer, and emphysema. Funding will be used for health care costs that are a rapidly growing expenditure for Missouri and all other states.

- Surcharge on income taxpayers with taxable income greater than $200,000 - $11.9 million – The proposal would increase the individual income tax on taxpayers with taxable incomes greater than $200,000 by five percent. Currently, an individual with taxable Missouri income of $200,000 owes the state about $12,000 in taxes. The proposal would increase his or her taxes by $600.

- Accelerated depreciation - $66.0 million – The proposal makes permanent the moratorium included in SB 1248 (2002) passed by the General Assembly. Federal accelerated depreciation would not be allowed to reduce Missouri taxes. Accelerated depreciation would still be allowed on federal returns.

Tax Cuts for Missouri Businesses and Consumers

The tax cuts proposed by the Governor include:

- Reduction in the corporate tax rate by one percentage point from 6.25% to 5.25% - The vast majority of corporations that pay Missouri taxes are severely penalized by other companies that bleed the state of money by using tax loopholes. By eliminating loopholes, we should reinvest some of the savings by reducing the corporate tax on all Missouri businesses. The reduction will help provide an economic incentive to Missouri businesses and spur economic activity, especially among small business where the greatest job growth takes place. The estimated revenue loss is $28 million.

- Sales tax holiday – The Governor recommends legislation to allow a sales tax holiday every August to help citizens with back-to-school purchases. An effective sales tax holiday will help Missouri consumers. It should also bring in shoppers from the eight contiguous states to make purchases and spur our economy. This will help Missouri merchants. The estimated revenue loss is $5 million, including holding local governments harmless from this state action.

Under the state constitution Missouri voters must approve any major increase in revenues. The General Assembly can raise some level of revenues without a vote but due to ambiguous language in the constitution this limit is widely subject to debate and possible litigation much like the state's revenue and spending limit. It is essential that the General Assembly send a major revenue increase to the voters. The Governor recommends that the vote be taken on Tuesday, July 1, 2003 at a special election. That date is the first day of the state's fiscal year.

TOBACCO SECURITIZATION

Last year the Governor recommended that the General Assembly pass legislation that would allow the state to sell a portion of the tobacco settlement proceeds in a process called "securitization." The General Assembly passed SB 1191 (2002) to give the state this option for up to 30 percent of the tobacco settlement proceeds. Tobacco securitizations have been completed by other states and are somewhat similar to revenue bond borrowing.

The goals of the securitization are to obtain upfront revenues from the tobacco settlement revenue stream and thereby get greater financial flexibility. During the past seven months the state has been working with a team of financial advisors to put forth a plan that maximizes revenues in the most fiscally prudent manner. All of the work that has been completed by the financial team shows the plan being used in the marketplace by other states for securitization is not the most beneficial one for Missouri. Under the traditional securitization structure the state would be forced to pay more interest than in a revenue bond borrowing. The high cost of this additional interest is supposedly needed to provide for the risk that is being transferred to bond holders. However, in the structure of the traditional tobacco securitization deal the bond rating agencies and the marketplace require the state to establish various bond reserves and pledges of revenues to protect the bondholders from the risk that the state is trying to transfer. In effect, the traditional tobacco securitization places a high cost upon the state with very little real risk transfer.

The state's financial team has recommended to the Tobacco Securitization Finance Authority that the state implement a hybrid tobacco securitization. The state's Board of Public Buildings would securitize the revenue from the tobacco settlement. An appropriation would be provided to pledge payment on the bonds in the event that the tobacco settlement revenue stream was disrupted or eliminated. The interest rates paid by the state on the bonds should be greatly reduced and thus we would not be penalized for attempting to transfer risk that the marketplace will not let us transfer.

The Governor recommends that the state proceed with the plan developed by the financial team. The Governor recommends a separate Fiscal Year 2003 supplemental appropriations bill be created. Quick action on the appropriations bill and the plan will provide a one-time means of assisting the state to balance the budget. Without these funds, additional withholdings or budget cuts will be necessary and protecting education will be more difficult.

FISCAL YEAR 2004 SUMMARY OF GENERAL REVENUE RECOMMENDATIONS

The general revenue fund provides for the services that Missourians think about when they think of state government. Funding from general revenue goes to local schools and higher education institutions. General revenue is also used to keep criminals locked up in our prisons and wayward juveniles in our youth services facilities. It is also used to operate our psychiatric institutions and facilities for the developmentally disabled. Indeed, over half of the general revenue staff in the budget are in institutions that operate 24 hours a day seven days a week.

The state receives federal funds but they can only be used for specific purposes authorized by the President and the U.S. Congress. In addition, the state has a variety of special, dedicated funds that the Missouri Constitution or the voters have directed be used only for specific purposes – the best examples being highway funds, lottery, and gaming. Neither the federal or other dedicated funds can be used for general government purposes.

The general revenue fund pays for the things that Missourians value the most. That is why when general revenue is in short supply the budget cuts that are required are the most painful. In Fiscal Year 2004 the net general revenue that is available to spend on services for Missourians will amount to only $6.16 billion without any additional revenue.

The Fiscal Year 2004 general revenue budget balances resources and obligations based on the revenue and refund estimate. The Governor directed the most thorough review of core budgets in the history of Missouri state government. This review identified $152.9 million in general revenue core budget reductions and redirections.

Fiscal Year 2004 base operating appropriations after core cuts are $6,063.0 million. New operating budget appropriations of $424.2 million are recommended to continue high priority existing programs, cover increasing Medicaid caseloads and costs, address security needs, respond to the expected growth in prison inmate population, provide for increased state employee health care costs, and implement new legislation.

This brings the total general revenue operating budget to $6,487.2 million, exclusive of court-ordered desegregation spending, tax refunds, and revenues dedicated to the Outstanding Schools Trust Fund.

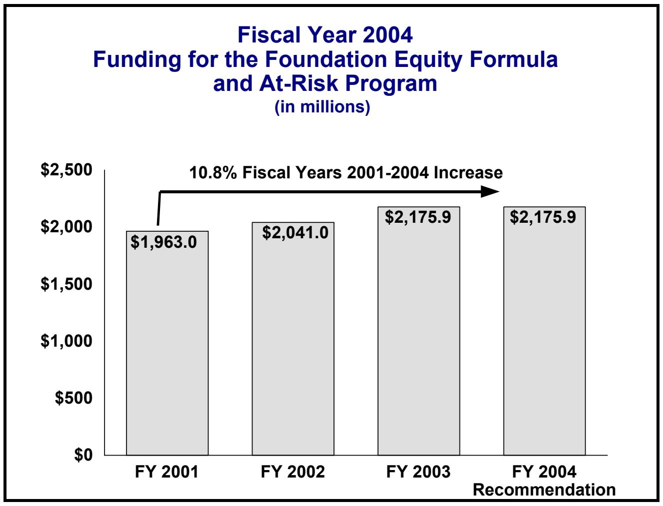
The Fiscal Year 2004 cost for the desegregation settlement is $16.5 million.

A total of $40 million has also been set aside for supplemental appropriations and increases in estimated appropriations.

MISSOURI'S FOUNDATION FORMULA FOR LOCAL SCHOOLS

Governor Holden's number one priority is the Foundation Formula – the primary assistance program for Missouri's 524 public school districts. In Fiscal Year 2003 when 17 other states cut funding for local schools the Governor fought hard to obtain a $134.9 million increase for the Foundation Formula. For Fiscal Year 2004 the Governor recommends that the Foundation Formula be protected from the budget reductions being implemented on other state agencies. Maintaining funding at the same level as Fiscal Year 2003 in these difficult economic times will help public school districts provide vital services. We are making measurable and important progress in improving student test scores, dropout rates, and learning and we must not begin to slide backward. The Foundation Formula provides funds to:

- Improve student academic achievement.
- Retain and attract qualified teachers.
- Provide professional development opportunities to teachers and school administrators.
- Provide resources for school districts to improve curriculum.
- Lower class sizes.



The Governor is adamantly opposed to removing gaming proceeds from the Foundation Formula and putting them into a Classroom Trust Fund with no suggested funding source to replace the money. This proposal is fiscally irresponsible. If the Foundation Formula funding is cut, school districts would encounter difficulties in retaining and attracting qualified teachers, keeping class sizes low, providing remediation and enrichment programs that help students succeed, and updating classes that will prepare students for the 21st century. Such a measure would take money away from rural, small and poorer districts and give it primarily to suburban, more affluent school districts. Every school district in Missouri deserves to have the same, equitable distribution of funding. To make such a proposed change simply invites expensive litigation on both the equity and adequacy of state funding.

OTHER ADDITIONAL RESOURCES FOR LOCAL SCHOOLS

Governor Holden's Fiscal Year 2004 budget includes $3.6 billion in direct state aid to local public schools. In addition to maintaining funding for the Foundation Formula, the Governor recommends:

- $11.7 million for Early Childhood Special Education for educational services provided to three- and four-year-old children with disabilities, bringing total state funding to $81.3 million.
- $2.8 million for payments to public schools for students placed by the Children's Division or the Department of Mental Health.

MISSOURI SENIOR Rx PROGRAM

For Missouri seniors, the affordability of prescription drugs continues to be a serious concern. Prescription drug coverage is still excluded from Medicare, and separate insurance to cover prescription drugs is very costly. For seniors with limited resources, choosing which prescription to fill is, unfortunately, a choice they often must make. Some seniors forego necessary medications, leading to increased illness and acute medical costs. During a special session called by Governor Holden in September 2001, the General Assembly approved the Missouri Senior Rx Program to provide drug coverage for seniors with individual incomes below $17,000 or household incomes below $23,000. The Governor recommends an increase of $28.5 million of the tobacco settlement payments to ensure an estimated 40,100 seniors benefit from this program.

MISSOURI'S PRISON POPULATION

Missouri statutes contain some of the toughest anti-crime provisions in the country. As a result, Missouri law now requires dangerous, violent criminals to serve longer sentences than ever before. These "get tough" provisions have resulted in a rapidly expanding prison population. During the last eight calendar years, Missouri's inmate population has grown by 11,272 inmates or 3.9 inmates per day. In comparison, during the decade of the 1980's, the population grew at a rate of 2.5 inmates per day. During calendar year 2002, the population grew at a rate of 4.1 inmates per day. In Fiscal Year 2004, the average daily inmate population is projected to be 31,484.

For a criminal justice system to be effective, incarceration space must be available and operated efficiently. The governor recommends providing a total of $36.4 million dollars to complete the openings of the Eastern Reception and Diagnostic Correctional Center in Bonne Terre and the Southeast Missouri Correctional Center in Charleston and to maintain current interim housing at Algoa Correctional Center, Fulton Diagnostic and Reception Center, and Western Missouri Correctional Center (Cameron).

The completion of the Eastern Reception and Diagnostic Correctional Center will help ensure that Missouri prisons adopt all the efficiencies available through modern prison design. Upon full opening, the institution will operate an 820-bed intake unit serving as the point of admission for offenders committed in the eastern regions of the state. The remaining 1,768 beds will serve as housing for high-custody male inmates. Similarly, the Southeast Missouri Correctional Center will contribute another 1,596 inmate beds. Both the Eastern Reception and Diagnostic Center, and the Southeast Missouri Correctional Center will be state-of-the-art correctional facilities that will serve Missourians not only by housing inmates but doing so through the most efficient means possible.

TREATMENT FOR SEXUALLY VIOLENT PREDATORS

Persons deemed by the courts to be "sexually violent predators" are committed to the custody of the Department of Mental Health for control and treatment until they can safely return to the community. The courts have also tended to place individuals in the department's custody pending final determination of their status. The program began in January 1999 at the Southeast Missouri Mental Health Center, and the number of individuals detained or committed has been steadily increasing. Governor Holden recommends an increase of $1.4 million for the program in Fiscal Year 2004.

REVIEW OF THE FISCAL YEAR 2003 BUDGET

The State of Missouri finished Fiscal Year 2002 with a balanced operating budget, but in very difficult financial condition. Net general revenue declined 3.5 percent and was about $119 million below forecast, which was within about two percent of the consensus revenue estimate. The Fiscal Year 2002 revenue shortfall was primarily due to a sharp decline in the stock market in calendar year 2001. The stock market decline greatly reduced income tax collections from capital gains. The decline in tax revenues associated with the stock market decline proved to be much greater than federal and most state revenue estimators anticipated. In addition to the stock market induced decline in individual income tax, sales and use tax collections remained sluggish, growing only 0.9%.

While the national economy has grown modestly over the last year, state revenue collection growth has continued to decline. Through the first six months of Fiscal Year 2003 net general revenue collections fell by 3.0 percent relative to the same six months of Fiscal Year 2002. This prompted Governor Holden to announce Fiscal Year 2003 budget withholdings of $67.1 million in early January.

THE ECONOMIC OUTLOOK
U.S. Economy and Outlook

After ten consecutive years of real growth as measured by real Gross Domestic Product (GDP), the U.S. economy fell into a recession in 2001. Fortunately, real GDP growth resumed in the final quarter of 2001 and that growth has carried over into 2002. For calendar year 2002 real GDP is expected to increase 2.4 percent. The inflation rate as measured by the Consumer Price Index is expected to rise 1.6 percent in 2002 and rise by 2.0 percent in 2003. This remains low by historical standards. With the economy still weak, the national unemployment rate is expected to be 5.8 percent for all of 2002 and be at 5.7 percent in 2003.

Looking ahead, the U.S. economic outlook is guardedly positive. Many leading forecasters, including Macroeconomic Advisers in St. Louis, expect the U.S. economy to improve over the next 18 months. For Fiscal Years 2003 and 2004, the Macroeconomic Advisers forecast is for real GDP to grow 2.7 percent and 3.4

percent, respectively. The inflation rate is expected to be 2.1 and 1.8 percent in the two fiscal years. The U.S. unemployment rate is expected to decline slowly from 5.9 percent to 5.4 percent over the forecast period. This combination of inflation and unemployment will produce a so-called misery index (inflation rate plus unemployment rate) of about 8.0 percent. It is notable that the misery index remains low by historical standards. From 1981 through 1992 the misery index averaged 11.7 percent.

While the U.S. economy has experienced slow growth over most of 2002, the outlook is for improved performance based on the following factors:

- The Federal Reserve has continued to pursue an expansionary monetary policy, lowering interest rates as recently as November 2002. The federal funds rate target was reduced from 1.75 percent to 1.25 percent.
- Oil prices are expected to remain relatively low. The price of imported oil is expected to be around $20 per barrel over the forecast period. This assumes a peaceful resolution of the Iraq situation.
- Consumer spending growth has held up well despite the stagnant economy of most of the last two years. This is expected to continue over the forecast period.

In summary, while the U.S. economy appears poised for better times, there is considerable downside risk. For the expected economic improvement to occur many things must happen. These include:

- A sustained stock market recovery.
- Continued strength in consumer spending.
- Business confidence and business hiring must accelerate. This must also lead to enhanced capital spending.
- Last and certainly <u>not</u> least, war with Iraq must either be avoided or be resolved very quickly. Should hostilities break out and not go well for the United States and its allies, oil prices are likely to rise sharply. This would almost certainly terminate the fragile economic recovery now under way. This, in turn, would severely impact state revenues.

The Missouri Economy and Outlook

As was the case with the national economy, the Missouri economy has been and remains under strain. The Missouri unemployment rate in November 2001 stood at 4.7 percent. One year later, the unemployment rate rose to 4.8 percent despite a gradually improving national economy. Over the course of the year, this rise in the Missouri unemployment rate represents a loss of about 13,500 jobs. The sagging economy has also depressed the rate of growth in Missouri personal income. After growing by 5.6 percent and 2.5 percent in Fiscal Years 2001 and 2002, respectively, growth of 3.5 percent is expected in Fiscal Year 2003.

On the positive side, the Missouri Purchasing Managers Index stood at 56.3 in November of 2002. This index purports to predict the direction of the state economy. An index number above 50 generally indicates improving economic conditions. On the downside, the fate of the Ford Motor Company plant in St. Louis County remains uncertain.

While the Missouri economy is under strain, a modest rebound is expected. The state economy remains diverse with strong presence in health care services and agriculture, as well as the travel and leisure industry. Employment in health care services has grown from 192,700 in 1990 to 237,000 in November of 2002. Missouri maintains a very favorable business tax climate evidenced by Missouri's ranking of 46th of 46 states that levy a corporate income tax in per capita corporate income tax. As the U.S. economy rebounds, growth in the Missouri economy will likely resume.

REVENUE ESTIMATES FOR FISCAL YEARS 2003 AND 2004

Forecasting revenues is an inherently difficult task, particularly during periods of economic transition and with much uncertainty abroad. Cooperation between the Governor and legislative leaders also remains critical for sound state budget policy. Governor Holden has worked cooperatively with House and Senate leaders to attempt to develop a consensus revenue estimate.

The revised Fiscal Year 2003 revenue estimate projects that net general revenue collections will decline by 3.1 percent. The Fiscal Year 2004 revenue estimate projects 2.5 percent net growth over the Fiscal Year 2003 revised revenue estimate.

Revenue Limitation Amendment

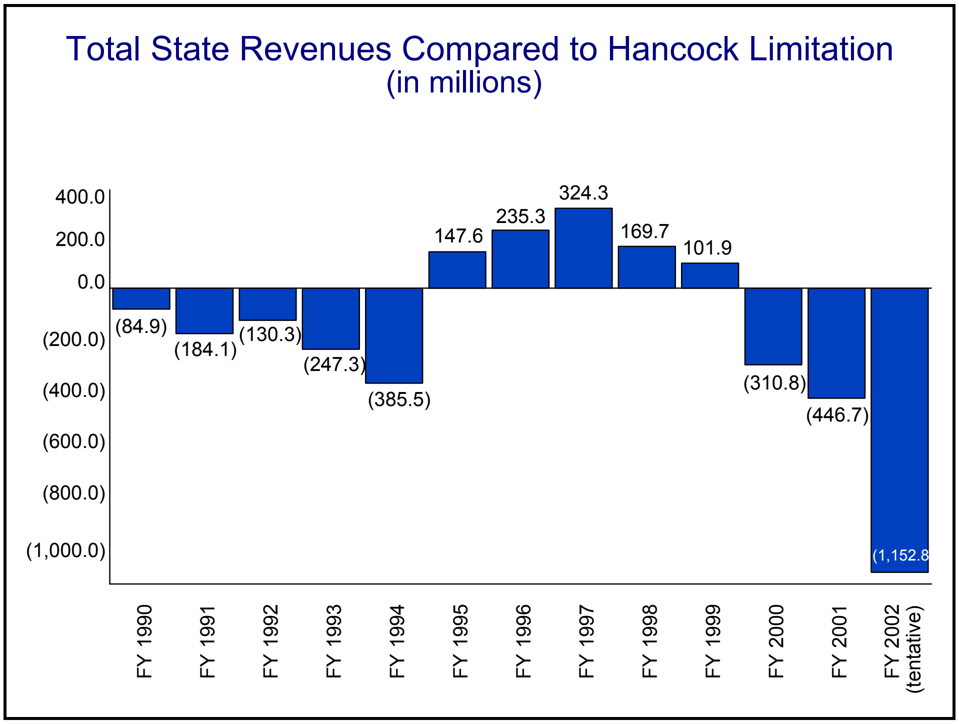
Article X of the Missouri Constitution establishes a revenue and spending limit on state government. The limit is about 5.6 percent of Missouri personal income based on the relationship between personal income and total state revenues when the limit was established and approved by voters in November 1980. Calculations made pursuant to Article X of the Missouri Constitution show that total state revenues for Fiscal Year 2002 were below the total state revenue limit by $1.15 billion – the greatest amount below the limit since it was established. As measured by the state's revenue limit, in Fiscal Year 2002 Missourians paid a smaller percentage of their personal income to state government than at any time since enactment of the limit in 1980.

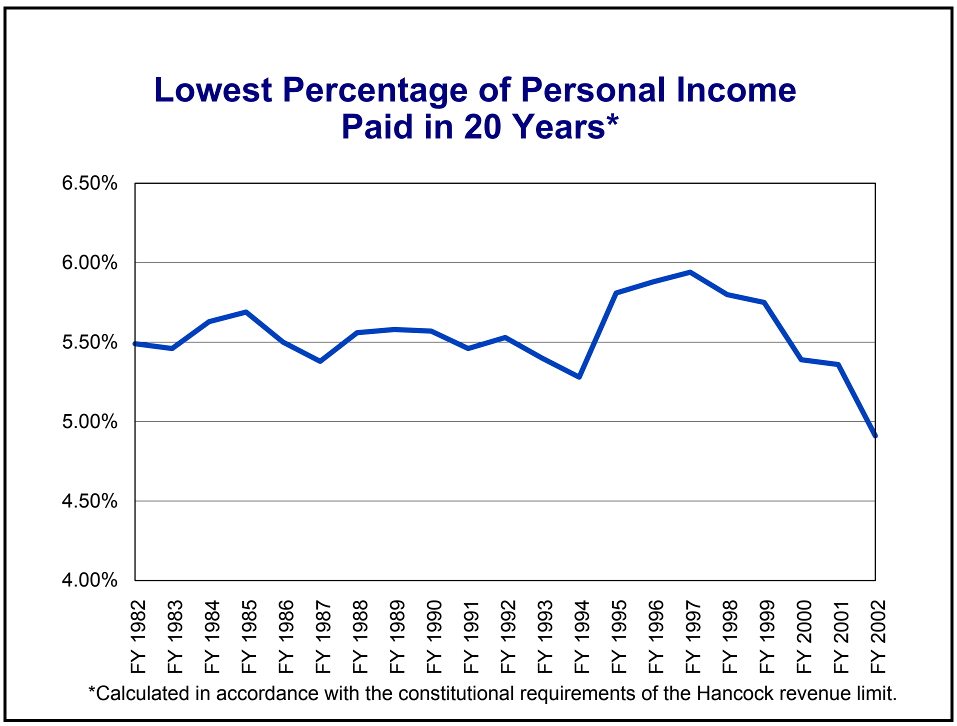
The Office of Administration projects that total state revenues will not exceed the total state revenue limit in Fiscal Year 2003 or Fiscal Year 2004. Indeed, the gap between what is expected to be collected and the revenue limit will continue to widen over the next few years. These preliminary calculations are subject to change as actual state revenue collections become known and as the federal government revises its estimates of Missouri personal income. In addition, the recent volatility in the stock market, if continued, could have an impact on this projection. As the federal tax cut phases-in over the next few years and continues to reduce state revenue growth, Missouri's total state revenues as a percentage of personal income will continue to fall significantly. The calculations project that total state revenues will be approximately $1.7 billion below the Article X revenue limit in Fiscal Year 2003 and $2.5 billion below the Article X revenue limit in Fiscal Year 2008.

These projections could change if the General Assembly were to pass legislation to increase revenue without a vote of the people. Per Article X of the Missouri Constitution revenue approved by the voters is not subject to the revenue and spending limit.

ECONOMIC PROJECTIONS

	Increase	
U.S.	**FY 2003**	**FY 2004**
Real GDP	**2.7%**	**3.4%**
Consumer Prices	**2.1%**	**1.8%**
Consumption Expenditures	**4.6%**	**4.4%**
Corporate Profits	**0.9%**	**6.9%**
MISSOURI		
Total Employment	**0.6%**	**1.5%**
Increase in Personal Income	**3.5%**	**4.5%**


Total State Revenues Compared to Hancock Limitation
(in millions)
400.0
200.0
0.0
(200.0)
(400.0)
(600.0)
(800.0)
(1,000.0)
(84.9)
(184.1)
(130.3)
(247.3)
(385.5)
147.6
235.3
324.3
169.7
101.9
(310.8)
(446.7)
(1,152.8
FY 1990
FY 1991
FY 1992
FY 1993
FY 1994
FY 1995
FY 1996
FY 1997
FY 1998
FY 1999
FY 2000
FY 2001
FY 2002 (tentative)


Lowest Percentage of Personal Income Paid in 20 Years*
6.50%
6.00%
5.50%
5.00%
4.50%
4.00%
FY 1982
FY 1983
FY 1984
FY 1985
FY 1986
FY 1987
FY 1988
FY 1989
FY 1990
FY 1991
FY 1992
FY 1993
FY 1994
FY 1995
FY 1996
FY 1997
FY 1998
FY 1999
FY 2000
FY 2001
FY 2002
*Calculated in accordance with the constitutional requirements of the Hancock revenue limit.

FISCAL YEAR 2004-FISCAL YEAR 2005 BIENNIAL CAPITAL IMPROVEMENTS BUDGET

Missouri uses a biennial appropriations process for capital improvements. This approach recognizes that most capital improvement projects take two or more years to complete, since significant advance time is required for technical design and the competitive bidding process before actual construction can begin. During the second year of the biennium, funding is provided for critical projects that were not envisioned when the biennial budget was adopted, for completion of projects begun in prior years, and for use of one-time revenues that become available for major infrastructure improvements. The very difficult financial circumstances faced by the state limits the biennial capital improvement budget to the following items:

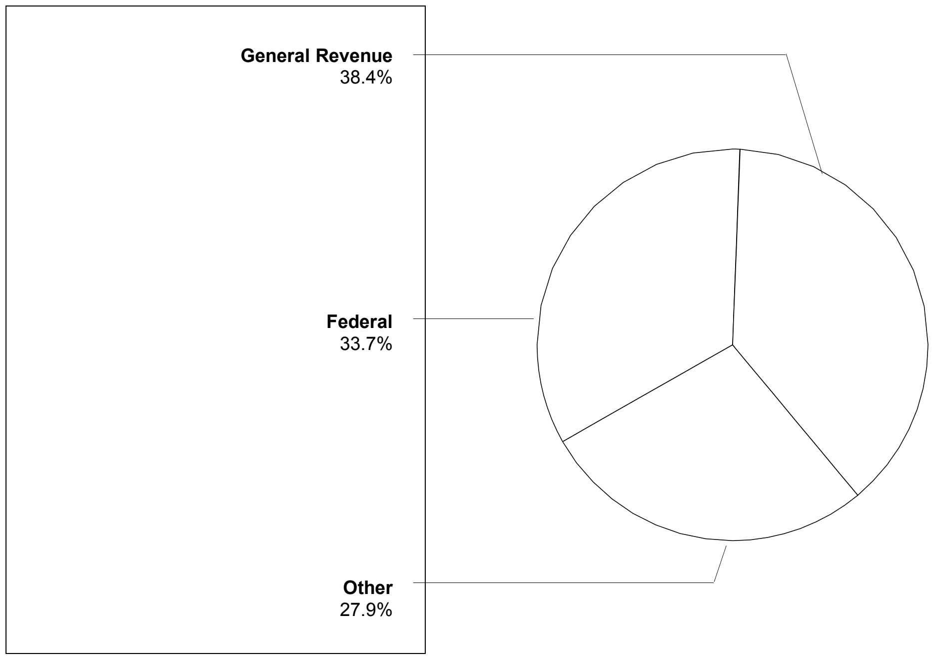
- $123.4 million for maintenance and repair to continue implementation of the voter-approved dedication of revenues for state-owned facilities.
- $96.7 million for projects at Missouri National Guard facilities located throughout the state, including $57.8 million for a specially designed aviation hanger and maintenance facility at the Springfield airbase. This facility will provide aircraft maintenance for the central region of the United States.
- $50 million to acquire, develop, improve, and repair Department of Conservation facilities.
- $30.7 million for construction of community corrections centers, including $3.1 million general revenue.
- $15.4 million for improvements at state parks and historical sites statewide.
- $8 million for various repairs and improvements at veterans' homes in Cape Girardeau, St. Louis, Cameron, St. James, and Warrensburg.

FISCAL YEAR 2004 COMPENSATION PLAN

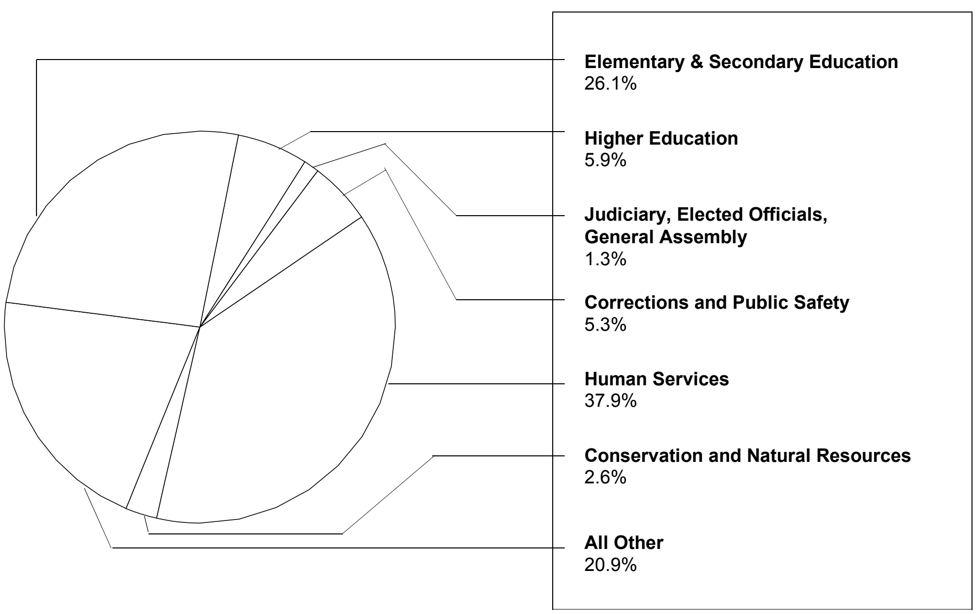
The state of Missouri competes in the marketplace for qualified, high performing employees. This becomes increasingly difficult when the state faces economic stress and salary increases are kept small or foregone to achieve budgetary savings that are necessary to maintain other services. Although resources are limited in Fiscal Year 2004, Governor Holden recommends a salary increase for those state employees who make the lowest annual salaries, as well as significant increases for employees' health care and other fringe benefits. Recommendations include:

- $36.2 million, including $20.4 general revenue, for a salary increase of $600 for each employee with an annual salary of not greater than $40,000 annually, including related fringe benefits. About 85 percent of state workers will receive a pay increase. The cost of the pay plan without accompanying fringe benefits is $30.7 million, including $17.6 million general revenue.
- $24.6 million, including $17.2 million general revenue, for increased costs to the state for participation in the Missouri Consolidated Health Care Plan.
- $15.7 million, including $10.2 million general revenue, for increased costs to the state for participation in the Missouri State Employees Retirement System.
- $1 million general revenue for increased costs to the state for workers' compensation claims.

TOTAL STATE OPERATING BUDGET
SOURCES OF FUNDS*
FISCAL YEAR 2004

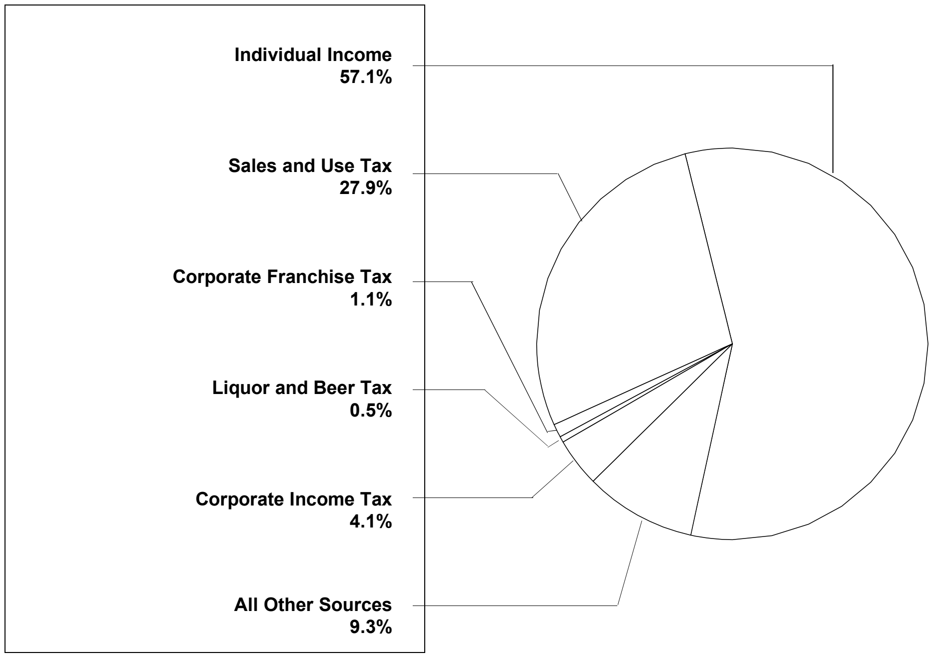


EXPENDITURES*
ALL FUNDS OPERATING BUDGET
FISCAL YEAR 2004

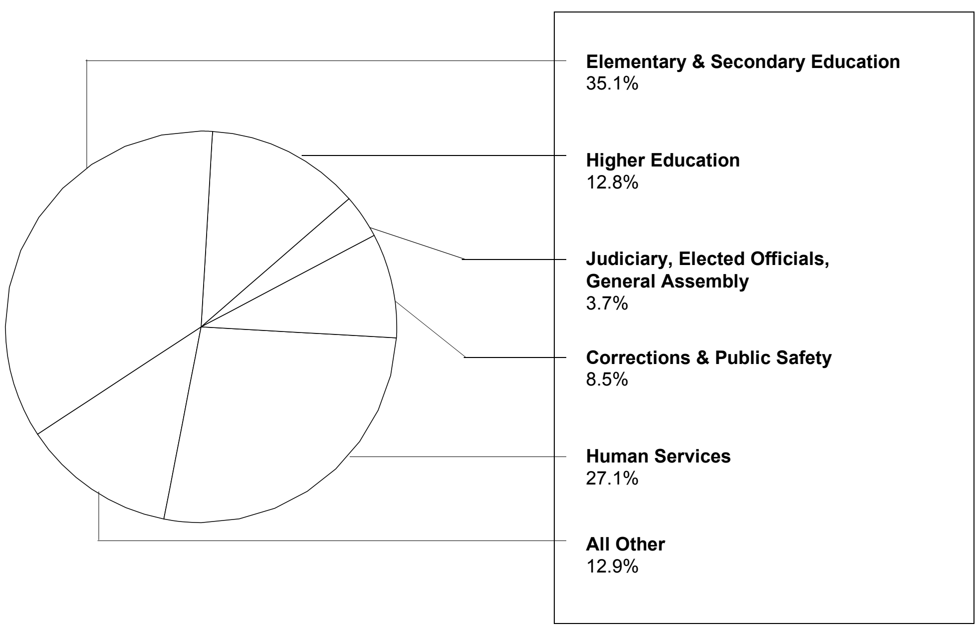


*Excludes tax refunds

REVENUES
GENERAL REVENUE RECEIPTS
FISCAL YEAR 2004

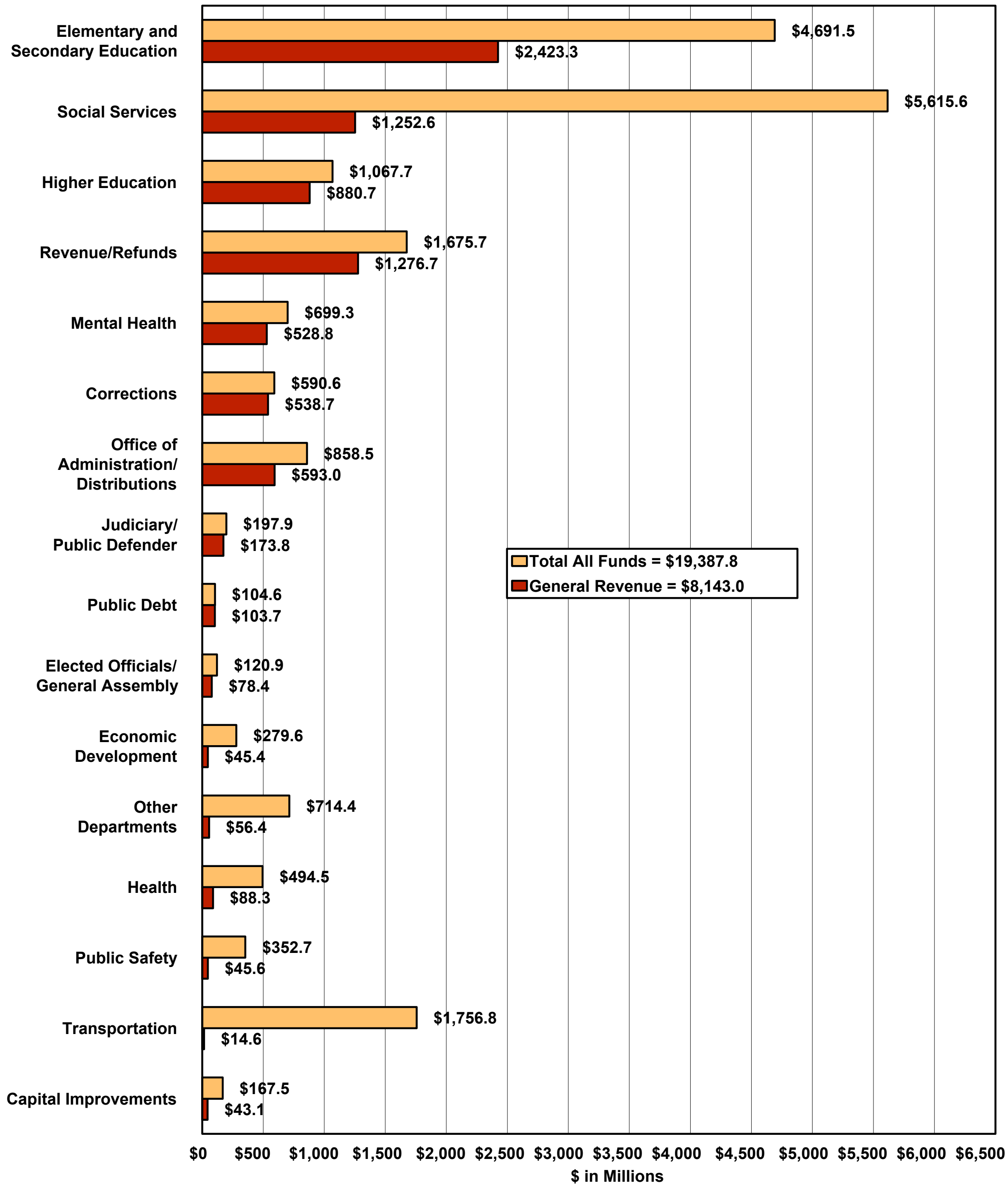


EXPENDITURES*
GENERAL REVENUE OPERATING BUDGET
FISCAL YEAR 2004



***Excludes tax refunds**

FY 2004 BUDGET RECOMMENDATIONS



Links to Financial Summaries and Tables:

General Revenue Receipts and Estimates
General Revenue Summary
Operating and Capital Budget Summary